No. 410

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CHARLES ELMORE CROPLEY

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

IN THE MATTER OF PROPOSED REORGANIZATION OF THE WESTERN TOOL & MANUFACTURING COMPANY, A CORPORATION,
Debtor.

OWEN N. PRICE, Trustee for Bondholders of The Western Tool & Manufacturing Co., and Roy Massena, E. J. Price, W. D. Hollister and W. T. Kettering, Bondholders' Protective Committee for Holders of Bonds of The Western Tool & Manufacturing Co.,
Petitioners,

vs.

JAMES G. GURNEY, Individually and on Behalf of Other Shareholders of The Western Tool & Manufacturing Co.,
Respondent.

ANSWER OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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JAMES G. GURNEY, Individually and on Behalf of Other Shareholders of The Western Tool & Manufacturing Co.,

Respondent.

ANSWER OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

STATEMENT OF THE CASE.

The Statement of the Case contained in the Petition for Writ of Certiorari is replete with allegations which are either wholly unsupported by the evidence or directly contradicted thereby, all of which will be pointed out in

respondent's Brief if this Honorable Court should direct the issuance of the Writ of Certiorari.

The nature of the proceedings is as follows:

A petition for reorganization under Chapter X of the Bankruptcy Act was filed by the owners of a majority of the outstanding capital stock of The Western Tool and Manufacturing Company, a corporation, on behalf of and in the name of that corporation.

The total number of outstanding shares of the corporation is 1120½, with a par value of $100.00 per share. The respondent stockholders are the owners of 682¾ shares (R. 4, 5, 29).

The only indebtedness of the corporation, at the time petition was filed, (other than current accounts payable and federal income and excess profits taxes for the year 1942) (R. 85) was a first mortgage indebtedness in the principal sum of $73,400 of which $300 in principal amount was outlawed by the statute of limitations (R. 2, 54, 55, 58). All of the outstanding bonds, except those barred by the statute of limitations, were and are on deposit with a Bondholders' Protective Committee (R. 55) under the terms of a Bondholders' Deposit Agreement dated November 1, 1923 (R. 80).

Shortly after default was made by the debtor corporation in the year 1923 in the payment of interest due upon the bonds aforementioned, the Bondholders' Committee was organized and there were transferred to this Committee, or its nominees, a majority of the outstanding shares of the corporation pursuant to the terms of a Voting Trust Agreement (R. 70, 71, 76, 78). The shareholders who filed the petition in the instant proceeding owned, at the time of filing, the number of shares and had on deposit with such Voting Trustees, the number of shares set opposite their respective names as follows (R. 29).

Stockholders	Shares Held	Shares deposited with Voting Trustees
James G. Gurney	7	
Stella Gurney	66	
James Gurney, Jr.		59
Harlan T. Hyde	107¼	443½

Subsequently James Gurney, Jr., died and his death was suggested of record in the Circuit Court of Appeals.

Since the formation of the Bondholders' Committee and the deposit of the majority of the stock with it, that Committee has controlled the Board of Directors of the Corporation (R. 7, 44-51).

On July 9, 1942, the Bondholders' Committee caused Owen X. Price, the Trustee under the first mortgage trust indenture (R. 17, 55) to institute foreclosure proceedings in the Court of Common Pleas of Clark County, Ohio, against the corporation (R. 18, 52). In that proceeding the Trustee was represented by the corporation's attorney (R. 44) and Mr. Kettering, one of the members of the Bondholders' Committee, was appointed Receiver, although he was a resident of the State of Illinois (R. 24). The corporation filed it answer to the petition for foreclosure, in which it admitted all the allegations contained in the petition and consented to the appointment of a receiver (R. 57).

On December 8, 1942 judgment was obtained in the foreclosure action (R. 59) in the sum of $134,698.21 which included interest at the rate of 8% per annum on the first mortgage bonds from November 1, 1929 to the date of such judgment, and at like rate upon interest coupons maturing subsequent to November 1, 1929 (R. 19). Interest was computed at this rate of 8% per annum despite the fact that the Bondholders' Committee had agreed to reduce that rate to 4% per annum (R. 31, 68). No sale has been

held under the foreclosure judgment. A motion to vacate that judgment was made by respondent, which motion was pending at the time the instant petition was filed. Prior to the institution of this proceeding, a demand was made upon the corporation by the respondent that the corporation itself institute this proceeding for reorganization under Chapter X of the Bankruptcy Act (R. 75). As demand was not complied with, respondent instituted such proceeding.

After this proceeding was instituted, the Bondholders' Committee filed a motion to dismiss the petition (R. 13) which motion was based upon the grounds: (1) that the petition was filed without the authority of the corporation or its Board of Directors and without their necessary assent or autho ity; (2) that it is unreasonable to expect that a Plan of Reorganization could be effected and that such reorganization is impossible because the only creditors (other than taxing bodies) are the Bondholders' Committee, and (3) that the petition was not filed in good faith but for the purpose of attempting to dictate the policy and management of the corporation and to delay or defeat the corporation's effort to pay its bonded indebtedness.

The corporation itself filed an "Application" (R. 15) wherein it stated that it did not consent to the jurisdiction of the Court and did not join in, consent or desire that the proceeding be maintained or any reorganization be had.

ARGUMENT.

THE LEGAL EFFECT OF THE PAST OPERATION OF THE DEBTOR CORPORATION AND OF THE ACTS AND DOINGS OF THE PERSONS WHO CONSTITUTE THE BONDHOLDERS' PROTECTIVE COMMITTEE.

A.

The conduct of the persons presently controlling the corporate affairs.

The only active members of the Bondholders' Committee since its formation in 1923 have been Enoch J. Price and William T. Kettering (R. 24). These same persons were the Voting Trustees of a majority of the outstanding stock of the corporation (R. 25) and Mr. Kettering, while a trustee, purchased some of the corporate stock (R. 25). The Voting Trust Agreement provided that in the event the Bondholders' Committee should fail to secure the refunding of the bond issue, the shares deposited with such Voting Trustees should be returned to the depositors (R. 77, 79). This Voting Trust Agreement was entered into on July 20, 1923 (R. 76, 78) and although the bond issue was never refunded during the succeeding 19 years and more, the shares were never returned to the depositing shareholders by the Voting Trustees. On the contrary, the Bondholders' Committee, as Voting Trustees, continued to vote those shares at each stockholders' meeting for the election of themselves, certain employees of the corporation, James G. Gurney (since 1929) and Harlan T. Hyde (until 1941) as directors of the corporation (R. 44, 46, 49, 50). The Trustees and the corporate employees under their control always constituted a majority of the Board.

In 1929, respondent became a member of the Board of Directors and then attempted to get the other Directors to increase the line of products made by the company and to revise and modernize its sales methods (R. 30). The other Directors refused to adopt these suggestions and had the company continue for many years with no, or practically no sales force, manufacturing only a few types of tools for which there was little demand (R. 31). No member of the Committee controlling the company's affairs was in actual charge or supervision of its operations but the company was, in fact, run by Erna Wheeler as General Manager, who, from 1931 to 1935 received $30.00 a week for her services as operating head of the company, and from 1935 to 1941 received $35.00 per week and thereafter $40.00 per week (R. 23). In operating the company no action was ever taken to increase its line of products, improve its sales methods or lower its production costs by the purchase of more efficient machinery and equipment but, on the contrary, the sole object of the Bondholders' Committee was to spend as little as possible in order to drain off all earnings for application upon the bonds (R. 65).

By May of 1942 the outstanding bond issue had been reduced from $90,000 to $73,000, of which $300 in bonds were outlawed. At that time the company had on hand a large amount of cash but instead of seizing this opportunity to restore the company to a sound financial condition at a time when the entire production of tools in the United States was insufficient to meet the demand, the Bondholders' Committee not only refused to acquire any new equipment but instead drained out of the company $16,000 and applied it on the bonded indebtedness (R. 19).

As respondent at that time was insistent upon the Voting Trustees returning to its owners the stock of Mr. Harlan T. Hyde and Mr. James Gurney, Jr., and also that

the changes he deemed necessary be made in company policy to increase profits and to preserve and increase the stockholders' equity, the Voting Trustees, in their capacity of Bondholders' Committee, caused Owen N. Price, as indenture trustee, to institute the foreclosure suit. Then, in their capacity of Directors, they caused the corporation to admit all the allegations of the foreclosure petition, to consent to the appointment of a receiver and to bring about the appointment of one of their number, Mr. Kettering, as such receiver. No attempt was made to require the Bondholders' Committee to fulfill its agreement that the bond interest should be reduced from 8% to 4% per annum, but, on the contrary, judgment was permitted to be entered in the foreclosure action for interest at 8% per annum from November 1, 1929 (R. 19).

Counsel was immediately obtained by the petitioning stockholders, when they learned of the foreclosure action, to intervene therein (R. 38). In that foreclosure action an order was entered providing for the payment of $3,000 attorneys' fees to the plaintiff's attorney, who, prior to the institution of that action, had been the company's attorney (R. 42) and for the payment of $600.00 to Owen N. Price as the plaintiff Trustee. These payments were made by Mr. Kettering, as Receiver, from the corporate funds despite the fact that the foreclosure proceedings had not and have not been completed nor the property sold therein.

As petitioners claim that the petition was filed without the authority of the corporation, its Board of Directors or its officers, the legal effects of the acts of that Committee, must be considered. Under the terms of the Bondholders' Deposit Agreement the members of the Committee were Trustees for the depositing bondholders (R. 80). Under the terms of the Voting Trust Agreement they were Trustees for the depositing shareholders (R. 76,

78). As Directors of the corporation they were Trustees for all stockholders, depositing and nondepositing, under an implied trust as distinguished from the express trusts created by the Bondholders' Deposit Agreement and the Voting Trust Agreement.

It is too well established to require citation of authority that Trustees are bound to exercise the utmost good faith and the highest degree of care and honesty for the protection of their beneficiaries. It is equally well established that the burden in each case of proving the exercise of that good faith and honesty is upon the Trustees. From the evidence introduced in the instant case, it appears incontrovertibly, that the Bondholders' Committee have violated their obligations to the stockholder beneficiaries by taking every step within their power to extinguish the stockholders' equity in the company and appropriate its entire assets for the benefit of the bondholders. They have consistently refused, during the course of their stewardship of the company's affairs, to take a single step to modernize its equipment, sales force and methods or to increase its line of products or production although sales thereof would be assured. They violated their own agreement to reduce interest on the bonded indebtedness from eight per cent (8%) to four per cent (4%) and caused a judgment to be procured in the foreclosure proceedings for more than $30,000 in excess of the principal and interest actually due under that agreement. As Directors it was their duty to attempt by every means possible to preserve the stockholders' equity, yet they chose to pursue the opposite course and oppose the instant proceeding.

B.

The validity of the election of the present Board of Directors of the corporation.

The Constitution of the corporation provides that notice must be given of all special meetings held to elect directors and that three fifths of the shareholders must be present at any meeting held for that purpose, to constitute a quorum. (Exhibit 22, offered R. 26, Printed R. 43, 44.)

Prior to the year 1941, the number of directors of the corporation was seven (R. 45) of which Harlan T. Hyde, one of the petitioning stockholders in this proceeding, was one. On March 17, 1941, a notice of what purported to be the annual meeting of the stockholders, to be held March 28, 1941, was sent to Mr. Harlan T. Hyde (R. 73). This notice stated: "Inasmuch as nothing of importance will be brought up at the meeting, it will not be necessary for you to attend." This notice was sent by the Secretary of the corporation at the request of the Committee (R. 74). Despite this representation to Mr. Harlan T. Hyde that he should not attend the meeting, the number of directors was, at that meeting, reduced from seven to five and Mr. Hyde was not re-elected a director (R. 45). At that meeting only 648½ shares of the outstanding 1120½ shares of the corporation were represented. As this did not constitute three-fifths of the outstanding shares of the corporation, as was necessary to constitute a quorum, such meeting was wholly invalid and such election was void. (*In re Fidelity Assurance Association*, 42 Fed. Supp. 973, 983; *In re Mississippi Valley Utilities Corporation*, 2 Fed. Supp. 995.)

The next annual meeting of the shareholders of the company was held on March 27, 1942. Admittedly no notice of this meeting was given to Mr. Harlan T. Hyde (R.

75) and at this meeting only 657½ shares of the corporation were represented, being less than three-fifths thereof (R. 46). At this meeting the Board of Directors holding office at the time of the institution of the instant proceedings were elected. Such election was also void, both for lack of quorum and also for lack of notice to Mr. Harlan T. Hyde.

As a result, the Company is without a legally constituted Board of Directors to conduct its affairs and who could authorize the filing of a Chapter X proceeding on behalf of the corporation. *In re Mississippi Valley Utilities Corporation*, 2 Fed. Supp. 995; *In re Fidelity Assurance Association*, 42 Fed. Supp. 973, 983. In the absence of a Board of Directors, it is the stockholders alone who can act for the corporation. Nevertheless the petitioning stockholders did, before instituting the Chapter X proceeding, demand of the corporation that it institute proceedings for reorganization under Chapter X (R. 75).

THE RIGHT OF THE STOCKHOLDERS TO INSTITUTE THE PROCEEDINGS FOR REORGANIZATION.

Even if it be assumed that a *de facto* board of directors exists, it necessarily follows that if, by virtue of being *de facto* directors there are conferred upon persons the rights and powers of *de jure* directors, then there are, necessarily, imposed upon them the duties of *de jure* directors to act for the protection of the corporation and the interests of its stockholders. It is clear that these directors have gone far beyond a passive neglect of the stockholders' interests by failing to seek a reorganization under Chapter X. Here, to the contrary, they have affirmatively attempted to destroy those interests by causing the institution of the foreclosure suit and by their opposition to the instant proceeding, which is the only one in which the stockholders' interests can be preserved.

However, we do not feel that it is necessary to determine whether the present Board of Directors is *de facto*, *de jure* or non-existent in order to determine the right of the stockholders to file the petition for reorganization. Even if it be assumed that the Board of Directors is a *de jure* Board of Directors, their conduct has been such as to give the stockholders the right to institute this proceeding.

Chapter X of the Bankruptcy Act, like its predecessor Section 77-B, was enacted to afford adequate relief to distressed corporations and the Act should be construed liberally to effectuate that purpose. (*Campbell* v. *Alleghany Corporation*, 75 Fed. 2nd 947.)

Courts of bankruptcy in a reorganization proceeding are essentially courts of equity and their proceedings are inherently in equity. (*Continental Illinois National Bank and Trust Company of Chicago* v. *C. R. I. P. R. R. Co.*, 294 U. S. 648, 675; 77 L. Ed. 1110, 1127.)

In discussing the intent of Congress in enacting Chapter X and Chapter XI of the Bankruptcy Act, this Court, in the case of *Securities Commission* v. *United States Realty Co.*, 310 U. S. 435, said at page 457:

> "While a bankruptcy court cannot, because of its own notions of equitable principles, refuse to award the relief which Congress has accorded the bankrupt, the real question is, what is the relief which Congress has accorded the bankrupt and is it more likely to be secured in a Chapter X or Chapter XI proceeding: In answering it we cannot assume that Congress has disregarded well settled principles of equity, the more so when Congress itself has provided that the relief to be given shall be 'fair and equitable and feasible.' Good sense and legal tradition alike enjoin that an enactment of Congress dealing with bankruptcy should be read in harmony with the existing system of equity jurisprudence of which it is a part."

Since *Howes v. Oakland*, 104 U. S. 450, the rights of stockholders of a corporation to prosecute or defend an equitable action in the name and on behalf of the corporation where the officers or directors themselves refuse to act or have interests adverse to those of the stockholders, is so well established as not to require citation of further authority. Such right has been recognized and rules governing the procedure to be followed in its exercise were established both in the former Federal Equity Rules and the present Federal Rules of Civil Procedure (Federal Rules of Civil Procedure, Rule 23-B).

Such right of the stockholders has also been established in bankruptcy cases.

Remington on Bankruptcy, Sections 370, 383

In re Beaver Cotton Mills, 275 Fed. 498; *Ogden v. Gilt Edge Consolidated Mines Co.*, 220 Fed. 723.

If in the instant case it be assumed, for purpose of argument alone, that the acts of the present officers and directors of the corporation did not constitute a violation of the duties imposed upon them by the express trusts and by law, by virtue of being directors, still the mere refusal or inability to act to protect the stockholders' interests gives the stockholders themselves the right to apply to the court of bankruptcy for their protection. *In re Dressler Producing Co.*, 262 Fed. 207.

If recourse can be had to a court of bankruptcy by the stockholders to protect their equity in a solvent corporation, there can certainly be no doubt that recourse can likewise be had to a court of bankruptcy under Chapter X by the stockholders, as the very purpose of Chapter X is to protect the rights and interests of junior lien holders and stockholders which would otherwise be extinguished, just as they would here be extinguished if the State Court foreclosure proceeding is consummated.

Respondent did not file the instant petition as a stockholder but in the right of the corporation for the failure of the corporation itself so to do. The very essence of a derivative action is that the stockholders are filing for and in behalf of the corporation and in the right of the corporation and that the benefits of the action redound to the corporation and not to the stockholders individually. The shareholders here are precisely within the provisions of Section 126 of Chapter X (11 U.S.C.A. 526) for the instant petition is filed by the corporation. As Chapter X must be read in harmony with the existing system of equity jurisdiction of which it is a part. (*Securities Commission* v. *U. S. Realty Co.*, 310 U. S. 434, 457; *Continental Illinois National Bank* v. *C. R. I. P. R. R. Co.*, 294 U. S. 648, 673; 77 L. Ed. 1110, 1127) Section 126 must necessarily be deemed to read "A corporation (or shareholders equitably entitled to appear on its behalf) . . . may file a petition under this Chapter."

It is not our contention that we filed an involuntary petition against the corporation in the capacity of creditors. Therefore the cases cited by opposing counsel that a stockholder is not a creditor within the meaning of the Bankruptcy Act granting the right to creditors to file an involuntary petition are wholly irrelevant to the issues here. The cases so cited to which we refer are *Bryan* v. *Welch*, 74 Fed. 2nd 904; *In Re Piccadilly Realty Co.*, 76 Fed. 2nd 257; *In Re Pittsburg Terminal Coal Corp.*, 30 Fed. Sup. 106; *In Re Liberminaux Corp.*, 10 Fed. Sup. 14; *In Re Phoenix Hotel Co.*, 13 Fed. Sup. 222 and *In Re Arcadia Furniture Co.*, 12 Fed. Sup. 477. Petitioners' citations of 3 *Remington on Bankruptcy*, 5th Ed., Section 1710 and *In Re Newport Corp.*, 96 Fed. 2nd 418, are inapplicable as they refer to the right of a stockholder to appeal in an ordinary bankruptcy proceeding.

BOARD OF DIRECTORS MUST ACT TO AUTHORIZE SUCH PETITION.

Petitioners obviously misconceive respondent's theory, which is that the instant petition was properly filed by the shareholders because of the failure of the purported board of directors to take action, because of the adverse interests of the purported board of directors and because there is neither a *de jure* nor a *de facto* board of directors which could authorize such action.

In the case of *White* v. *Penelas Mining Co.*, 105 Fed. 2nd 726, the Court refused to dismiss a petition for reorganization upon a claim that there was no possibility of reorganization, and found that there was a probability of a reorganization being accomplished.

In re Fidelity Assurance Association, 42 Fed. Sup. 973, is direct authority for respondent's contention that the debtor corporation has no board of directors who could authorize the filing of a petition under Chapter X.

Voeller v. *Neilston Warehouse Co.*, 311 U. S. 531, 85 L. Ed. 322, involved the question of whether an Ohio statute fixing the method of determining the amount to be paid a dissenting shareholder was unconstitutional as depriving the majority shareholders of their right to participate in fixing that valuation when the board of directors failed to follow the statutory procedure. This Court held the statute constitutional as the shareholders rights were protected if the directors did follow the statutory procedure while if they failed so to do the shareholders had a right of action against the directors for negligence. We do not understand petitioners to contend that an action against the directors is the shareholders only remedy, as authority on the question of derivative actions is overwhelmingly to the contrary.

MISCONDUCT AUTHORIZING STOCKHOLDER TO FILE PETITION.

Although the misconduct of the directors in attempting to serve, in a fiduciary capacity, adverse interests is only one of the grounds which entitled respondent to bring the instant proceeding, yet that course of action brings this proceeding precisely within the rules laid down in *Hawes* v. *Oakland*, 104 U. S. 450.

Petitioners' claim a failure to show the stockholders made earnest effort to obtain redress. Petitioners then claim that although effort was made to obtain such redress, the time given the corporation to act was insufficient. This statement comes with ill grace in view of the fact that these same gentlemen had brought about the institution of foreclosure proceedings, had filed an answer therein admitting the right to foreclose, have, in the District and Circuit Courts, opposed, by every means within their power, the consummation of the reorganization upon respondent's petition and are, in this Court, displaying equal determination to bring about its dismissal. If they wished to join in respondent's petition for reorganization by formal action, respondent would have welcomed it.

It is stated that the company drifted along for 19 years and intimated that now that the company is making a profit there is something shameful or wrongful in the stockholders attempting to protect their equity because that equity is more valuable now than it was in the past. With equal justification it can be said that for those 19 years the bondholders took no action to deprive the shareholders of the value of their equity and that only when its value became enhanced did the bondholders, for the first time, take the affirmative action of the foreclosure

suit. Until that affirmative action was taken there was neither necessity for nor right in the stockholders to take any action to protect their interests.

Petitioners advance as an excuse for their permitting this company to drift along for 19 years, and permitting its machinery and equipment to become antiquated and obsolete and for their refusal to modernize or increase its line of products that this is a matter of "business judgment". For their failure to accept Mr. Gurney's offer in 1942 to pay the fee of an industrial engineer for making an inspection and recommendations as to the plant and to accept his suggestion that the cash on hand be used to purchase modern equipment, or even to borrow from defense agencies set up for that purpose, appellees advance other excuses. This time that it is common knowledge that it would "probably" have been impossible to procure such new equipment and that it would have been expensive, that labor could not be secured, that the duration of the emergency is unknown, that a similar program had been ill advised during the first World War, at which time it is claimed the Hydes and the Gurneys were in control of the company. Not only is there not a scintilla of evidence in the record supporting such excuses or such contentions, but petitioners now attempt to use the results of this policy of letting affairs drift as an argument that the company is insolvent and there is no equity for the stockholders because the earnings resulting from that unbusinesslike policy were not large. Logically, it would seem that the results of the policy adopted by the other directors being so poor, the policy urged upon them by Mr. Gurney since 1929 was the only one that displayed any exercise of good business judgment, and that the stockholders should be given an opportunity to rectify the mistakes and misconduct of the Bondholders' Committee.

It should here be noted that the demand to institute the Chapter X proceeding was not made upon the directors, but upon the corporation (R. 75).

The illustration offered by petitioners of the "good faith" of the directors and the Committee is illuminative of what they deem to be a proper exercise of fiduciary duties. They state that they could have caused the corporation to pay to themselves, as a Committee, funds as interest on the bonds and then have ased such funds, not for the purpose for which the funds were disbursed, but to purchase bonds at a discount of 75% to 90% and then held such bonds as a claim against the corporation for the full face amount. It is elementary that a fiduciary, or an agent, in using trust or his principal's funds to purchase obligations, acquires them for the beneficiary or the principal at the discounted price and cannot enforce them at a higher amount. The actual practice followed by the Trustees, for which praise is asked and good faith claimed, not only was the only course which they could legally have adopted but also resulted in a benefit to the other bondholders by increasng the value of the remaining bonds outstanding and the amount of interest which could be paid thereon. No explanation is offered as to what interest of the shareholders was subserved when these directors caused the corporation to vote to themselves as the Bondholders' Committee $1,000 for Committee expenses (Exhibit 23, offered R. 42, printed R. 48).

VOTING TRUST IS VALID.

Under this subdivision petitioners argue only that the Voting Trust Agreement was valid at its inception. Assuming that to be true, its provision for termination upon failure to refund the bond issue, is equally valid. As almost twenty years passed without such refunding by the

Trustees, the trust necessarily terminated and the shareholders were entitled to the return of their stock and may treat the trust as terminated.

Laches could not be asserted by the Trustees against the depositing stockholders for that defense may be presented by trustees against their beneficiaries only for delay occurring subsequent to a disclaimer of the trust by the trustees (*Bonnell* v. *Brown*, 11 C.C. (N.S.) 58; affirmed 80 Ohio St. 710), nor could the beneficiaries of the trust be estopped, for they have taken no affirmative action in reliance on which the Trustees changed their position. The case of *Warren* v. *Pim*, 66 N. J. Eq. 353, does not support even the contention that the trust was valid at its inception as it holds that the voting trust there under consideration was illegal and void as its object and aim was not the equal benefit of all shares.

AS TO CLAIM THAT DIRECTORS WERE ILLEGALLY ELECTED

As above stated the shareholders' meetings at which the present purported directors were elected were void for lack of quorum and lack of notice.

AS TO DE FACTO DIRECTORS

Petitioners contend:

(a) That the five persons purporting to act as directors are *de facto* directors if they are not *de jure* directors, and

(b) that as *de facto* directors their acts are valid and binding upon the corporation and cannot be collaterally attacked.

In essence petitioners' position is that as *de facto* directors they alone are entitled to protect the stockholders'

interests and if they determine to refuse to utilize Chapter X, which is the only proceeding affording a protection for those interests, and even though they have instituted the foreclosure action, no one else has the right or power to save from destruction that which they, *themselves*, *have* set about to destroy.

None of the cases cited supports the contention that the invalidity of the election of directors cannot be collaterally raised, and in fact, two of them are authority to the contrary.

In *Ehrman* v. *Union Central Life Insurance Co.*, 35 O. S. 324, 339, there is no reference on page 339, nor elsewhere, to *de facto* directors; the only question involved was whether plaintiff corporation acquired a note in an *ultra vires* transaction. Nor did *Clarke* v. *Thomas*, 34 O. S. 46, involve a question of *de facto* directors. The sole question there was whether a stockholder, who had received notice of a stockholders meeting called for the purpose of increasing the capital stock, and who subscribed to the new issue, was estopped from presenting the defense, in a suit for the balance of his subscription price, that some other stockholder had not received notice of the meting, which other stockholder had both accepted and paid for his new stock.

In *First Presbyterian Society* v. *Rogers*, 12 O. S. 248, the Ohio Supreme Court, by reversing the lower Court, held that there should be determined, in an action for the recovery of real property, a collateral proceeding, the question of who were, in fact, the *de jure* or *de facto* directors of plaintiff corporation.

The case of *First Presbyterian Society* v. *First Presbyterian Society*, 25 O. S. 128, 133, required a determination as to which of two groups, each claiming to be the corporate members of the Church Society, was entitled to a fund

bequeathed to the Society. The executor defended on the grounds that this question could be determined only by *quo warranto* and not in that collateral proceeding. The trial court ordered the non-party group made a party defendant and determined the rights of each group in that collateral proceeding, which procedure was approved by the Supreme Court of Ohio in its affirmance.

RATE OF INTEREST.

By Exhibit 7 (Offered R. 20, Printed R. 68) it is disclosed that the Bondholders' Committee had agreed to reduce the rate of interest to four per cent; by the uncontradicted testimony of Mr. Gurney (R. 31) it appears that as late as May of 1942 Mr. E. J. Price admitted that the Bondholders' Committee had agreed to reduce the interest to four per cent. Petitioners argue here that the Committee had no power to make such an agreement, yet on page 28 of their brief they take the position that the Committee, not the bondholders, is the creditor, and they allege that the Committe are the real holders of the bonds for every purpose connected with enforcing rights under them.

Petitioners also contend that an agreement to reduce the rate of interest would be without consideration and illegal. Such is not the law.

In the case of *Adams Recreation Palace* v. *Griffith*, 12 O. O. 134; 53 Ohio App. 216, the Court held valid an executory agreement between landlord and tenant reducing rent on the ground that the imminent insolvency of the lessee and the desire of the lessor to retain the tenant was sufficient consideration. This case was discussed with approval in 13 Ohio O. 343 and cited with approval by the Supreme Court of Ohio in *Gholson* v. *Savin*, 19 Ohio O. 309, 314; 137 Ohio St. 551.

In the instant case, the corporation's inability to pay the full eight per cent interest and the desire of the Committee to have the corporation continue in business and pay interest at a reduced rate, was sufficient consideration for the agreement.

RATE OF INTEREST ADJUDICATED.

Respondent does not contend that petitioners failed to observe every technical step required to complete the destruction of the stockholders' interest in the foreclosure proceeding. The observance in that suit of the legal technicalities cannot excuse either its illegal object or their failure to defend it on behalf of the corporation. Much less can their actions there excuse their opposition to this proceeding, which is the only one now available to protect the corporation and the stockholders' equity therein. Petitioners now claim that respondent could have appeared in the foreclosure proceeding to undertake the duties of defending it for the corporation, yet contend that respondent cannot protect those interests in this proceeding. It seems hardly likely that the strenuous objections here interposed against the right of any but petitioners to appear for the corporation would not have been made in the foreclosure suit which they themselves caused to be instituted. Respondent was not guilty of laches as counsel was retained immediately upon learning of the foreclosure suit (R. 38) and as above pointed out a trustee cannot assert laches until he has disclaimed the trust.

LACHES OF COMPLAINING STOCKHOLDERS.

Petitioners also attempt to impute laches to the stockholders for failure to take action for many years prior to the foreclosure proceeding. The answer to that contention is two fold. First, until some affirmative action violative

of their trust had been taken by the Trustees (here the institution of the foreclosure suit) there was no reason for the stockholders to act nor did a cause of action accrue to them. (*Langworth* v. *Hunt*, 11 O. St. 194; *Ormsby* v. *Langworth*, 11 Ohio St. 653; *Crimp* v. *Union Bank*, 352 Ill. 93; 185 N. E. 236; *Jensen* v. *Snow*, 131 Me. 415; *Bonnell* v. *Brown*, 11 C.C. (N.S.) 58; affirmed 80 Ohio St. 710.) Second, there has been no change in position by the Trustees, in reliance upon the shareholders non-action, which resulted in a detriment to the Trustees.

DUTY OF CORPORATION TO FILE A PETITION FOR REORGANIZATION.

Respondent does not deny that where a corporation has a valid board of directors, the members of which are honestly and fairly performing their duties for the best interests of the corporation, the question of whether or not a petition for reorganization of that corporation should be filed is one to be determined by the board of directors, but where, as here, the interests of the directors are antagonistic to that of the corporation and it is for the best interests of the corporation that a reorganization be had and such directors not only wilfully fail to institute such a proceeding, but actively oppose it, then the stockholders, and the stockholders, alone may act. The Circuit Court of Appeals in its opinion said no more (R. 119). In the instant case not only were the interests of those persons purporting to act as directors of the corporation antagonistic to that of the corporation, but the corporation had no valid board of directors who could act for it (*In Re Mississippi Valley Utilities Corporation*, 2 Fed. Sup. 995; *In re Fidelity Assurance Asso.*, 42 Fed. Sup. 973; *In Re Dressler Producing Co.*, 262 Fed. 257.)

As was said in the case of *Eggers* v. *National Radio Co.*, 281 Pac. 58, 61, 208 Cal. 308:

> "It would be a reproach to the law if the stockholders in such a case as this were remediless. * * * The right of a stockholder to take means to conserve the corporate property to prevent its loss to the corporation or the impairment of its value, proceeds upon the principle that whatever is or may be inimical or injurious to the corporation is or may be an injury to the stockholder, and he is therefore entitled to equitable relief."

DUTY OF CORPORATION TO MAKE DEFENSE IN FORECLOSURE SUIT.

Not only did the Bondholders' Committee, in its *alter ego* of Board of Directors fail to make a defense in the foreclosure action—they instituted and prosecuted that action to judgment.

While respondent's motion to vacate that foreclosure judgment was pending, the instant proceedings were instituted to prevent the destruction of the stockholders' equity and to permit the corporation to continue in business, to serve which purposes Chapter X was enacted.

It is incontrovertible that directors must act for the best interests of the corporation and its stockholders. Even if the foreclosure action had been instituted by independent parties, it would have been the duty of the Directors to cause the corporation to present every defense it possessed in that action. Possessing at least a partial defense, it presented none.

Respondent further contends that if the corporation had possessed no defense to the foreclosure action itself, it would have been the duty of these directors to institute this proceeding as the need for reorganization is present,

both to protect the stockholders' existing equity and to preserve the good will value of the corporation as a going concern.

Each and every action of the petitioners here has been violative of their duties as directors and the instant proceeding is the only one which can prevent the petitioners from attaining their objective and which will preserve the corporation.

SOLVENCY OF THE CORPORATION.

Petitioners contend that respondent failed to prove his charge that excess interest had been charged and allowed in the foreclosure action. There was no failure of proof but a lack of opportunity to present such proof. The hearing was held in the District Court upon petitioners' motion to dismiss the petition, not upon an answer to it which raised any issue of fact, and the petition was dismissed in the District Court upon the ground that the stockholders had no right to institute the proceeding for and on behalf of the corporation. Subsequent to the reversal of that judgment by the Circuit Court of Appeals, the District Court has referred the cause to a Special Master under a general reference with instructions to first determine and report upon the question of good faith in the filing of the petition. The Circuit Court of Appeals in its opinion stated that there could be no good faith unless an interest existed for the stockholders. It is not necessary to argue the correctness of that statement inasmuch as such an interest does exist for the stockholders.

Subsequent to the reference to the Master, and to enable respondent to prepare for such hearing, petitioners submitted to respondent the balance sheet of the corporation as of December 31, 1943, and the income tax return filed by the corporation for the year 1943. According to its own books, as of that date the corporation had current assets

of approximately $165,500.00 consisting of cash, accounts receivable, Treasury tax savings notes and inventories of $31,133.54; it had fixed assets of approximately $50,000.00 and a contingent tax rebate of approximately $14,000.00. Its only liabilities were current accounts payable of approximately $3,700.00, reserve for income taxes of approximately $108,350.00 and the mortgage debt which had been reduced to $116,168.29.

It appears that during the year 1943 the corporation had a profit before federal taxes of $134,168.73 with a reserve set up for those taxes of $108,353.45, which would indicate a net profit for the year 1943 of $25,755.28.

According to this balance sheet the liabilities exceeded the assets by $7,130.45. By the appraisal made in the foreclosure proceedings (Exhibit 21, offered R. 26, printed R. 89) the fixed assets were appraised at $7,008.45 more than their value as given on the balance sheet of December 31, 1942 (Exhibit 19, offered R. 26, printed R. 84-86). This would decrease the book deficit to $121.98. The corporation has continued, since December 31, 1943, to operate at a substantial monthly profit. The balance sheet or book value reflects no good will value nor any value as a going concern, both of which are proper subjects for consideration as to whether an equity exists for the stockholders and, in fact, this Court has stated that earning capacity is the true test of value. (*Consolidated Rock Co.* v. *DuBois*, 312 U.S. 510; also see Finletter: The Law of Bankruptcy Reorganization, page 555, *et seq.*) Nor does the balance sheet give consideration to respondent's contention that the mortgage debt as shown thereon should be reduced by approximately $35,000.00 by reason of excess interest accrued and paid.

The mortgage debt, as shown on the balance sheet of December 31, 1943, of $116,168.29 includes not only the excess interest of approximately $30,000.00 included in the judgment decree, but also the sum of $10,710.08 repre-

senting interest at 8% per annum from the date of that decree to December 31, 1943. If respondent's contention is correct that that debt should bear interest at the rate of only 4% per annum, the book liability should be decreased by the further sum of $5,355.04 with a corresponding increase in the stockholders' equity.

A PLAN OF REORGANIZATION CAN BE EFFECTED.

Petitioners base their contention that no reorganization can be effected upon the ground that they, as the Bondholders' Committee, will oppose any plan of reorganization. No plan of reorganization has been proposed and if, after hearing, the District Court finds that the petition was filed in good faith it could hardly do otherwise than appoint a Trustee rather than leave the debtor in possession. Under such circumstances the Trustee alone can present a plan of reorganization.

The present opposition of the Bondholders' Committee to any plan of reorganization which might be proposed is wholly irrelevant, and will remain irrelevant until the feasibility of the plan itself has been determined. (*In re 263 W. 38th St. Corporation*, 37 Fed. Sup. 667; *In re Castle Beach Apartments*, 113 Fed. 2nd 762.)

Secondly, the petitioners are not the actual owners of the bonds but merely representatives of the owners. As such they must act for the benefit of the owners and have no right to vote upon a plan of reorganization in the place and stead of the owners themselves. (*In re Castle Beach Apartments*, 113 Fed. 2nd 762.)

Section 212 of the Bankruptcy Act, 11 U.S.C.A. 612, specifically provides that the Court may disregard any provision of the deposit agreement by which the creditor is represented and may authorize an accounting there-

under. In the instant case not a single one of the fifty bondholders (R. 29) is objecting to this proceeding but the objections are all being advanced by the petitioners. The record does not disclose that any member of the Bondholders' Committee owns a single bond of the company. Not only is it the bondholders themselves who should determine whether any plan which may be presented is fair and equitable, but in the light of the actions of this Committee a Court would be fully justified in disregarding its refusal to consent to a plan of reorganization on the ground of bad faith. (Bankruptcy Act, Section 203, 11 U.S.C.A. 603.) In fact the acceptance of a plan by anyone other than the creditors themselves must be specially authorized by the creditors. (Remington on Bankruptcy, Sec. 4516, 1942 Sup. page 111.)

The petitioners have even less authority to object to the propriety of the filing of respondent's petition than they would have to consent to or refuse to accept a plan of reorganization when one is presented, as it is the creditors alone who can make such objections. (*In re Loeb Apartments*, 89 Fed 2nd 461.)

The case of *In re Witherbee Corp.*, 88 Fed. 2nd 251, not only does not support the statement for which petitioners cite it but it was there held that the Bondholders' Committee could vote the bonds only if the bondholders themselves were first given an opportunity to withdraw them from deposit and had failed so to do.

Respondent does not deny that the petition should be dismissed if it is unreasonable to expect that a plan of reorganization could be effected, for the statute provides that that is one of the elements to be considered in determining whether the petition is filed in good faith. (Bankruptcy act, Sec. 146, 11 U.S.C.A. 546.) But the question of good faith is yet to be determined in this case

and a reference has been made to determine that question. Therefore, petitioners' contention, at this time, that it is unreasonable to expect a reorganization to be effected is premature as well as unauthorized and irrelevant.

A cause should be dismissed for lack of good faith only if it is clear that there is no reasonable possibility of reorganization and that the petition was filed for the purpose of delaying creditors. (*Witters* v. *Ebsarz Co.*, 95 Fed. 2nd 746; *In re Julius Roehrs Co.*, 115 Fed. 2nd 723; *Snyder* v. *Fenner*, 101 Fed. 2nd 736; *In re 325 E. 72nd St.*, 53 Fed. Sup. 997.)

THIS PROCEEDING WILL BEST SUBSERVE INTERESTS OF INTERESTED PARTIES.

It is apparent that the pending State Court foreclosure proceedings will destroy the corporation as a going concern and will extinguish the shareholders' equity for that is its object and its purpose. All of the corporate assets, except cash and accounts receivable, will be sold under the foreclosure decree and the cash and accounts receivable will be applied upon the deficiency, which, obviously, will be large in view of the fact that the book value of the fixed assets and inventories is only $80,000.00 as compared to the foreclosure decree indebtedness in excess of $116,000.00. No proceeding other than the instant one exists which will serve to maintain the corporate existence, enable it to continue as a going concern and preserve the stockholders' equity.

CONCLUSION.

The decision of the Circuit Court of Appeals is clearly correct applying, as it does, well established principles to the instant facts and since the petitioners have shown no sufficient reason for review by this Court it is respectfully submitted that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

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